The Regulatory Reform Process

By U.S. Senator Edward E. Kaufman

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Mr. President, after months of careful consideration, landmark financial reform legislation moves towards final passage. While this bill is a vast improvement over the existing regulatory structure, I believe it should go further with respect to erecting statutory walls that address the fundamental problem of "too big to fail." I will support the conference report, though I do so with significant reservations about a missed opportunity to enact needed structural reforms that would better prevent another financial crisis.

Ultimately, given the make-up of the Senate and the requirement of 60 votes, this was the best bill that could pass. For those who wish the bill was stronger, let there be no confusion about where the blame lies. It is because almost every Senator on the other side of the aisle did everything they could to stall, delay and oppose Wall Street reform.

To be sure, the bill that has come out of conference includes some extremely important reforms. It establishes an independent Consumer Financial Protection Bureau (CFPB) with strong and autonomous rulemaking authority and the ability to enforce those rules for large banks and nonbanking entities like payday lenders and mortgage finance companies. In addition, it requires electronic trading and centralized clearing of standardized over-the-counter derivatives contracts as well as more robust collateral and margin requirements. The bill's inclusion of the Kanjorski provision will give regulators the explicit authority to break up megabanks that pose a "grave threat" to financial stability. And I was pleased that the bill includes a provision I helped develop to give regulators enhanced tools and powers to pursue financial fraud.

Through the Collins provision, the bill also establishes minimum leverage and risk-based capital requirements for bank holding companies and systemically risky non-bank institutions that are at least as stringent as those that apply to insured depository institutions. In light of the failures of past international capital accords, this requirement will set a much-needed floor on how low capital can drop in the upcoming Basel III negotiations on capital requirements. It will also ensure that the capital base of megabanks is not adulterated with debt that masquerades as equity capital.

That being said, unfortunately, I believe the bill suffers from two major problems. First, the bill delegates too much authority to the regulators. I've been around the Senate for 37 years. As I said on the Senate floor on February 4th of this year and in several speeches since then, I know that many times laws are not written with hard and clear lines. Laws are a product of legislative compromise, which often means they are vague and ambiguous. We often justify our vagueness by saying the regulators to whom we grant statutory authority are in a better position than we are to write the rules – and then to apply those regulatory rules on a case-by-case basis. But, as I have said, this was not one of those times. This was a time for Congress to draw hard lines that get directly at the structural problems that afflict Wall Street and our largest banks.

Despite repeated urging from me and others to pass laws that would help regulators to succeed, Congress largely has decided instead to punt decisions to the regulators, saddling them with a mountain of rulemakings and studies. The law firm Davis Polk has estimated that the SEC alone must undertake close to 100 rulemakings and more than a dozen studies. Indeed, Congress has so choked the agencies with rulemakings and studies, the totality of the burden threatens to undermine the very ability of the agencies to accomplish their ongoing everyday mission. I for one urge the agencies to triage carefully these required rulemakings and studies, establish a hierarchy of priorities, and ensure that the agencies do not shift all resources to new rules meant to address old problems to such a degree that they fail to stay on top of current and growing problems. I will have more to say on this subject in a future speech.

Second, the legislation does not go far enough in addressing the fundamental problem of "too big to fail." Instead of erecting enduring statutory walls as we did in the 1930s, the bill invests the same regulators who failed to prevent the financial crisis with additional discretion and relies upon a resolution regime to successfully unwind complex and interconnected mega-banks engaged across the globe. I am also disappointed that key reform provisions like the Volcker Rule and the Lincoln swaps dealers spin-off provision were scaled back in conference.

The bill mainly places its faith and trust in regulatory discretion and on international agreements on bank capital requirements and supervision. After decades of deregulation and industry self-regulation, it is incumbent upon the regulators now to reassert themselves and establish rulemaking and supervisory frameworks that not only correct their glaring mistakes of the past, but also anticipate future problems, particularly risks to financial stability. Unfortunately, the early indications we are seeing out of the G-20 and so-called Basel III discussions are not encouraging, as critical reforms are already being watered down and pushed back in part because some foreign regulators carelessly refuse to heed the risks posed by their megabanks.

The legislation also puts in place a resolution authority to deal with these institutions when they inevitably get into trouble. While such authority is absolutely necessary, it is not sufficient. That is because no matter how well Congress crafts a resolution mechanism, there can never be an orderly wind-down of a $2-trillion financial institution that has hundreds of billions of dollars of off-balance-sheet assets, relies heavily on wholesale funding, and has more than a toehold in over 100 countries. Of course, since financial crises are macro events that will undoubtedly affect multiple megabanks simultaneously, resolution of these institutions will be enormously expensive. And until there is international agreement on resolution authority, it is probably unworkable.

Given the history of financial regulatory failures and the enormous burden of rulemakings and studies with which the regulators are being tasked, Congress has a critical oversight responsibility. Congress first must ensure that the regulators have enough staff and resources at their disposal to follow through on their serious obligations. Just as important, Congress must monitor the regulatory phase of this bill's implementation closely to ensure that the regulators don't return to "business as usual" when the experience of the most recent financial crisis fades into memory.

Volcker Rule

For example, in addition to granting great discretion to regulators on how they interpret the ban on proprietary trading at banks, the scaled-back Volcker Rule contains a large loophole that allows megabanks to continue to own, control and manage hedge funds and private equity funds under certain conditions. Most notably, it includes a de minimis exception that permits banks to invest up to three percent of Tier 1 capital in hedge funds and private equity funds so long as their investments don't constitute more than three percent ownership in the individual funds.

The impact of a supposedly small three percent de minimis exception for investments in hedge funds and private equity firms has the potential to be massive. For example, a $2 trillion bank that has $100 billion in Tier 1 capital would be able to invest $3 billion into hedge funds. Since that $3 billion could only constitute three percent ownership, it would need to be invested alongside at least $97 billion of funds from outside investors. The bank would therefore be able to manage $100 billion in hedge fund assets, a massive amount equal to the current size of the largest hedge funds in the world combined. What's more, that $100 billion in assets can be leveraged several times over through the use of borrowed funds and derivatives into overall exposures that could exceed a trillion dollars. And given the ambiguity of the legislative language, unless clarified by a rulemaking, some commentators have indicated that megabanks could potentially provide prime brokerage loans to hedge funds they partially own and run.

Fortunately, the final bill does place costs on banks' de minimis investments in hedge funds and private equity funds. Specifically, the legislation requires a 100% capital charge on these proprietary investments, making them expensive for banks to hold. While this may be a helpful deterrent, I am concerned that it will not be enough of one, particularly when considering how lucrative and risky an activity it is for banks to run hedge funds and private equity funds.

The overarching problem is that banks will continue to be able to offer and run – never mind, partially own – risky investment funds. Even though the scaled-back Volcker Rule includes a "no bailout" provision, I have concerns about the credibility of that edict. Under any circumstance, the failure of a massive hedge fund run by a megabank would pose serious reputational and financial risks to that institution.

Just look at what happened when the structured investment vehicles (or SIVs) of Citigroup and other megabanks began to falter. Because of the reputational consequences of liquidating these funds and allowing them to default on their funding obligations, they were bailed out by the megabanks that spawned them even though the SIVs themselves were generally separate, off-balance-sheet entities with no official backing from the banks.

Finally, the strength of the core part of the Volcker Rule – the ban on proprietary trading – will depend greatly on the interpretation of the regulators. They will ultimately be the arbiter of whether broad statutory exceptions for "market making" or "risk-mitigating hedging" or "purchases" or "sales" of securities on "behalf of customers" are allowed to swallow the putative prohibition. I therefore urge the regulators to construe narrowly those activities that constitute exceptions to proprietary trading to ensure that the Volcker Rule has some teeth in it.

Swaps Dealer Spin-Off

Senator Lincoln's original swap dealer spin-off provision would have prohibited banks with swap dealers from receiving emergency assistance from the Federal

Reserve or FDIC. By essentially forcing megabanks to spin off their swap dealers into an affiliate or separate company, this section would have helped restore the wall between the government-guaranteed part of the financial system and those financial entities that remain free to take on greater risk. It would also have forced derivatives dealers to be adequately capitalized.

While the final bill includes the Lincoln provision, it limits its application to derivatives that reference assets that are permissible for banks to hold and invest in under the National Bank Act. Since that exception covers interest rate, foreign exchange and other swaps, it ultimately exempts close to 90% of the over-the-counter derivatives market. Regulators must therefore reduce counterparty exposures by requiring the vast majority of derivatives contracts to be cleared and calibrate carefully the amount of capital that bank derivative dealers must maintain. Only then can we be sure we never again face a meltdown caused by excessively leveraged derivatives exposure that no regulator helps to keep in check.

Conclusion

The financial reform bill places enormous responsibilities and discretion into the hands of the regulators. Its ultimate success or failure will depend on the actions and follow-through of these regulators for many years to come. It is estimated that various federal agencies will be charged with writing over 200 rulemakings and dozens of studies. Many of the same regulators who failed in the run-up to the last crisis will once again be given the solemn task of safeguarding our financial stability. Like many others, I am concerned whether they have the capacity and wherewithal to succeed in this endeavor.

I repeat again, Congress has an important role to play in overseeing the enormous regulatory process that will ensue following the bill's enactment. The American people, for that matter, must stay focused on these issues, if just to help ensure that Congress indeed will fulfill its oversight duty and its duty to intervene if the regulators fail. Likewise, although I will be leaving the Senate in November, I will be watching closely to see how the regulators follow through on the enormous responsibilities they are being handed.

Let us not forget why reform is so necessary and important. After years of Wall Street malfeasance and the systematic dismantling of our regulatory structure, our financial system went into cardiac arrest and our economy nearly fell into the abyss. Wall Street, which had grown out of control on leverage and financial gimmickry, blew up. More than 8 million jobs were wiped out; millions more have lost their homes. We spent trillions of dollars in monetary easing and emergency measures to avert the wholesale failure of many of our megabanks. Not surprisingly, we continue to feel the aftershocks of the worst financial crisis since the Great Depression. The banks are not lending. Fed Chairman Bernanke just days ago urged them to do more for small businesses. Companies and consumers alike remain shaken in their confidence. And despite dramatic stimulus measures, the economic recovery has been slow and tentative.

Many of the opponents of Wall Street reform would like to make the dubious claim that the recovery is being held back by uncertainty about future regulations and taxes. In reality, it is being held back by the financial shock and the fact that we are still in a period of financial instability and undergoing an excruciating process of deleveraging. Even now it is unclear whether a European banking crisis based on their holdings of sovereign debt will continue to impede that recovery.

It is therefore imperative that we build a financial system on a firmer foundation. The American economy cannot succeed unless we restore and maintain financial stability. We simply cannot afford another financial crisis or continued financial instability if the American economy is to succeed in the coming decades. Getting financial regulation right and maintaining it for years to come should be one of this nation's highest priorities because the price of failure is far too high.